Financial Development and Economic Growth: New Lessons from Small Open Economies

Horatio M. Morgan

Ryerson University

12. September 2013

Financial Development and Economic Growth: New Lessons from Small Open Economies

Horatio M. Morgan, Ph.D.
Assistant Professor, Global Management Studies Department
Ted Rogers School of Management
Ryerson University
350 Victoria Street
Toronto, Ontario
Canada, M5B 2K3
E-mail: horatio.morgan@ryerson.ca
Telephone: +1(416) 979-5000 ext. 2526
Fax: +1(416) 979-5266

Financial Development and Economic Growth: New Lessons from Small Open Economies

ABSTRACT

This paper develops a political economy framework to explain the underlying financial mechanisms through which redistributive policies may affect both the relative level of per capita income growth rates, and the relative stability of growth paths across countries. It proposes that *socio-politically motivated* redistributive policies characterized by financial exclusion may undermine financial intermediation. By extension, it argues that politically unconnected productive firms may face binding financial constraints in normal times, and both politically connected and unconnected firms may jointly face binding financial constraints in abnormal times. This may give rise to an output gap in normal times that diverges in abnormal times. It is shown that this theoretical framework can explain growth disparities between Jamaica and Barbados since the 1960s. In addition, it offers new lessons on the importance of effective long-run pro-poor-pro-growth strategies for developing countries with acute income inequality.

Key words: Barbados; Economic growth; Financial development; Institutions; Jamaica; Politics; Redistributive policies.

JEL classification: G0; O0

Financial Development and Economic Growth: New Lessons from Small Open Economies

1. Introduction

There is a burgeoning literature that almost uniformly points to financial development as a precondition for long-run economic growth (Levine, 1997, 2005); that is, countries with banks that perform financial intermediation relatively well and have more developed stock markets are expected to grow faster over the long term, all else equal. While disagreements remain about the fundamental determinants of financial development, there is an emerging view that politics matters (Rajan and Zingales, 2003). The primary purpose of this paper is to develop a theoretical framework that explains the mechanisms through which politics affects financial intermediation; and in turn, how the latter affects both the relative level of per capita income growth rates, and the relative stability of the growth paths across countries.

It will be shown that this *politics-finance-growth* perspective can explain observed growth disparities between Jamaica and Barbados since the 1960s. But this choice of countries perhaps raises the question of what may be learned from an account of the growth experiences of two small tropical island states when neither is generally known to represent an economic miracle by international standards; however, this paper illustrates that they warrant special attention for at least two reasons. First, for developing countries with acute income inequality, they illustrate very well the pitfalls of not carefully choosing long-run economic growth strategies that are both pro-poor and pro-growth over the long term.

Second, the Jamaica-Barbados growth disparities are not adequately explained by the *law-finance-growth* perspective. According to this perspective, legal institutions influence corporate finance and financial development, which in turn influence long-run economic growth

(Beck, Demirgüç-Kunt and Levine, 2003a; Beck et al. 2003b; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997, 1998, 1999, 2000; Levine 1998, 1999). Specifically, countries that are willing and able to efficiently enforce well-defined laws that protect the rights of creditors and minority shareholders encourage savers or investors to confidently place their funds in both private and public debt and equity markets. When allocated to the most profitable projects, these funds may relax external financing constraints; and thereby facilitate firm growth, industrial expansion and labor productivity growth.

Thus, to the extent that the legal systems of countries are tied to their legal heritage (i.e. English common law and French civil law), cross-country differences in per capita income over the long term may be explained in terms of cross-country differences in legal origins. However, this does not seem to bear out in the Jamaica-Barbados case. Since the 1960s, a real per capita income gap has emerged between Jamaica and Barbados, which dramatically widened during the oil shock episode of 1973 (Henry and Miller, 2009). Based on the law-finance-growth perspective, this observed growth disparity between Jamaica and Barbados is not expected. This is so because both countries share a common institutional heritage: not only did they operate under the same coercive plantation system that was controlled by the same colonial master (Williams, 1970); but after gaining independence four years apart (Jamaica in 1962, and Barbados in 1966) they went on to model their legal and political systems after those of Britain (i.e. English common law and a Westminster Parliamentary democracy that is dominated by two political parties) (Antoine, 1999; Payne, 1993).

The Jamaica-Barbados growth puzzle presents two questions that are not adequately addressed either by the law-finance-growth perspective, or the politics-finance-growth perspective in its current form (Rajan and Zingales, 2003). First, why has the standard of living

been falling in Jamaica relative to Barbados since the 1960s? Second, why is the growth path apparently less stable for Jamaica relative to Barbados? This paper attempts to fill these gaps in the extant finance-growth literature by addressing these two questions, among others; specifically, it also uses the disparate Jamaica-Barbados growth experiences to address the question of how developing countries with acute income inequality may successfully reduce poverty without sacrificing growth over the long term.

To establish the theoretical foundation for a comparative analysis of the growth experiences of Jamaica and Barbados, this paper expands the existing politics-finance-growth perspective (Rajan and Zingales, 2003). In particular, it introduces the concepts of *socio-politically motivated* (SPM) redistributive policies as opposed to *socio-economically motivated* (SEM) redistributive policies: an *SPM redistributive policy* is a public policy that is motivated by the desire to equalize economic outcomes and engenders financial exclusion; meanwhile, an *SEM redistributive policy* is a public policy that is primarily motivated by the desire to equalize opportunity and engenders financial inclusion.

It is argued that SPM redistributive policies may lead to a relatively slow per capita income growth rate, and a relatively unstable growth path over the long term. These growth outcomes may be traced to the adverse and potentially persistent effects of such policies on financial intermediation. Specifically, redistributive policies of the socio-political variety may stand in the way of financial sector reforms that are geared toward improving the efficiency and stability of the banking system; thus, they may not only undermine financial intermediation, but also contribute to banking crises.

In general terms, this theoretical framework suggests that actual output will be lower than potential output if bank credit is disproportionately allocated to politically connected, but low-

productivity firms in normal times (i.e. periods void of crises or major external shocks); and the output gap that emerges in normal times will diverge in abnormal times (i.e. periods of crises or major external shocks). These expected outcomes are consistent with relatively low per capita income in normal times, and a generally unstable growth path as the economy traverses both normal and abnormal times. Unlike Barbados, Jamaica adopted SPM redistributive policies under democratic socialism in the 1970s. Thus, to the extent that both countries have approximately the same economic growth potential, this theoretical framework can explain: (1) why real per capita income grew at a slower rate for Jamaica throughout the relatively normal times of the 1960s; and (2) why aggregate output contracted more in Jamaica relative to Barbados during the abnormal times of the 1970s when both economies were buffeted by the 1973 oil shock.

There are two notable studies that are most related to this paper. The first study is by Henry and Miller (2009). They provide what may be called a *macroeconomics-growth* perspective on the growth disparities between Jamaica and Barbados. This account similarly acknowledges that the law-finance-growth view does not adequately explain the growth disparities of these two countries. Its essential message is that Barbados has economically outperformed Jamaica because it practices "good" economics (i.e. fiscal discipline) with greater fortitude and consistency. However, as this paper will show, this account is incomplete. This paper expands on the work of Henry and Miller (2009) by showing, for instance, that there was greater income inequality in Jamaica relative to Barbados well before they gained independence in the 1960s. This finding is non-trivial. Importantly, it implies that Jamaica's post-independence challenge was not merely to grow on par with Barbados, but to also close the initial income inequality gap.

As will be shown in this paper, Jamaica successfully closed its pre-independence income inequality gap with Barbados by the 1970s, but in its place emerged a considerably wide real per capita income gap. Thus, Jamaica has been in search of an elusive pro-poor and pro-growth strategy at least since the 1960s. Since an understanding of this reality is not conveyed in the emerging macroeconomics-growth perspective, it is not well-placed to adequately inform policymakers on how to proceed more fruitfully in formulating an effective long-run pro-poor-pro-growth strategy. However, by squarely addressing this issue, this paper has the potential to not only advance the economic growth agenda in Jamaica; but more generally in developing countries that are currently grappling with the social and economic problems associated with acute income inequality and poverty.

As will be also illustrated in this paper, the persistent underperformance and virtual breakdown of financial intermediation in Jamaica may be directly linked to the adverse effects of the SPM redistributive policies that it adopted under democratic socialism in the 1970s. Although the core ideas of democratic socialism appear in Henry and Miller (2009), its implications for financial intermediation are not explored. Therefore, by shedding new light on this issue, among others, this paper provides a more complete treatment of the disparate Jamaica-Barbados growth experiences.

Finally, the study by Iyare and Moore (2011) is also closely related to this paper. In particular, its present time series econometric evidence which suggests that while there is a systematic bi-directional relationship between various measures of financial development and long-run economic growth in Barbados, financial development is not found to have a direct impact on long-run economic growth in Jamaica. While these results are interesting, the authors do not adequately explain why the financial sector seems to have direct impact on long-run

economic growth in Barbados and not in Jamaica. The politics-finance-growth perspective that is articulated in this paper fills this theoretical void; in particular, it explains why, and the extent to which, financial intermediation was compromised in Jamaica relative to Barbados over the last three decades.

The remainder of this paper is organized as follows. The next section develops a theoretical framework that establishes the links between SPM redistributive policies and financial intermediation; and in turn, between the latter and economic growth performance. Next, this theoretical framework is then used to evaluate the growth experiences of Jamaica and Barbados since the 1960s. The final section summarizes the key theoretical insights and empirical results; and concludes by discussing their policy implications, and potentially fruitful directions for future research.

2. Theoretical Framework

According to the political-economy framework of Rajan and Zingales (2003), politics may get in the way of growth-enhancing financial sector reforms. Specifically, self-serving politicians may impede long-run economic growth by granting exclusive privileges to politically influential or rent-seeking individuals or groups. However, it is not only the desire to remain in power that may lead politicians to engage in such behavior. There are at least three other potential motivations for the adoption of redistributive policies in one form or another. These are discussed in the next section that immediately follows.

SPM and SEM Redistributive Policies

If the state has incomplete control over the use of force and violence, the government may be inclined to grant rents to apparently powerful individuals or groups to reduce the likelihood of social unrest and violence, and thereby maintain social order and political

continuity (Acemoglu and Robinson, 2013; North, Wallis, Webb and Weingast, 2013). In addition, to the extent that the government embraces equity or social justice as its core value, it may be prepared to transfer resources in one form or another from individuals or groups deemed well-off to others deemed less fortunate.

In these first two cases, redistributive policies are primarily predicated on both social and political considerations rather than purely economic ones. In other words, they represent departures from market-based principles that emphasize competition and efficiency. In the first case, the government is willing to undermine market competition by granting monopoly privileges because the perceived efficiency gains from competitive markets do not adequately compensate for the perceived risks and costs of social and political instability. In the second case, the government either deliberately or inadvertently sacrifices the efficiency gains from competitive markets by placing too much emphasis on the equalization of economic outcomes. These two cases may be conceptualized as examples of socio-political motivations for redistributive policies.

Socio-political motivations for redistributive policies are to be distinguished from socio-economic motivations. This brings us to the third motivation for redistributive policies. There may be a strong economic rationale for redistributive policies when imperfections in capital markets are either difficult or too costly to resolve; and thereby perpetuate financing constraints and wealth inequality. For instance, if there is a unique invariant wealth distribution, and the rapid accumulation of capital among the rich increases the availability of funds for the poor through a "trickle-down" process, then there is room for government intervention in a free market economy (Aghion and Bolton, 1997). Specifically, not only will transfers from the rich to the poor accelerate the rate at which the economy converges to its steady-state distribution of

wealth, but such transfers may foster production efficiency because they relax the financing constraints that the poor disproportionately face; hence, the latter will have a stronger incentive to pursue lucrative investment opportunities under financially inclusive policies.

The primary objective of the government in this latter case is to achieve greater equality of opportunity rather than the equality of income. While greater equality of opportunity through financially inclusive policies may increase the rate at which the poor are able to improve their welfare as the growth rate of per capita income accelerates, the government accepts that even when everyone becomes better off over time, some individuals will still be better off than others in the in long term.

Importantly, SEM redistributive policies that emphasize financial inclusion have pro-poor and pro-growth characteristics should be particularly appealing to developing-country governments that have to deal with the social and economic problems that are associated with acute income inequality and poverty (Beck and Demirgüç-Kunt, 2008; Beck, Demirgüç-Kunt and Martinez Peria, 2007). SEM redistributive policies may not only achieve social cohesion by reducing income inequality, albeit not perfectly; but may also be superior to SPM redistributive policies in terms of long-run economic growth outcomes. In what follows next, I discuss in greater detail the implications of SPM redistributive policies for financial development.

SPM Redistributive Policies and Financial Development

In practical terms, redistributive policies of the socio-political variety may feature the erection of entry barriers that effectively shield inefficient, but politically connected firms from competition at home and abroad. Similar barriers in the form of financial repression engender financial exclusion. Specifically, politically connected players in the banking sector may earn monopoly profits, or enjoy exclusive access to cheap bank credit in the presence of not only

entry restrictions, but also controls on credit allocation and the interest rates offered or charged on savings or loans, respectively. But a financially repressed banking system cannot be expected to effectively perform financial intermediation. Still, vested interests have an incentive to organize and resist financial reforms because they risk losing the rents that they enjoy under financial repression (Olson, 1965; Stigler, 1971). A similar pattern of organized resistance is anticipated in response to proposed international trade and financial policies that may unleash competitive forces, and erode monopoly rents.

Importantly, it is not only private interests that have an incentive to block financial sector reforms; the government may also have an incentive to do so as well. To see why this may be the case, it is sufficient to recognize that SPM redistributive policies incur fiscal costs that may not be fully covered by current tax revenues. To the extent that these policies are sustained, the government may have to borrow at home or abroad to finance the potentially large fiscal deficits that such policies may generate. In this case, financial repression may enable the government to raise funds at home under more favorable terms. Since financial repression essentially enables the government to implicitly tax domestic savings, the incentives to block financial sector reforms will be particularly strong under fiscally burdensome redistributive policies of the socio-political variety.

In sum, the foregoing discussion suggests that while SPM redistributive policies may engender financial exclusion, SEM redistributive may foster financial inclusion. This leads to the following three related propositions:

Proposition 1: In normal times, state-controlled or politically directed banks will disproportionately allocate bank credit to politically connected low-productivity firms on

favorable terms, while disproportionately rationing credit to privately owned and independently operated high-productivity firms.

Proposition 2a: In normal times, an output gap (i.e. difference between actual output and potential output) will emerge; and

Proposition 2b: The normal-time output gap will diverge in abnormal times.

Since the foregoing discussion already offers arguments in support of proposition 1, it is worthwhile to reflect on propositions 2a and 2b. According to proposition 2a, if a country's banking system primarily operates under political directives, then its actual output will be lower than its potential output because the most productive firms are credit rationed; and thereby unable to implement their investment and production plans. It follows that the actual (real) per capita income will be lower than its potential level, all else equal; alternatively, the growth rate of real per capita income will be slower than what is attainable given the economy's resources.

Meanwhile, proposition 2b suggests that countries with politically controlled banking systems will have a relatively unstable growth path. This is so because external shocks may trigger multiple binding external financing constraints (for both politically connected and unconnected firms) when the efficiency of financial intermediation is compromised, and difficult times force the government to reduce bank credit allocations even to politically connected firms. To the extent that financially constrained firms jointly reduce output, the contractionary effect of a single external may be amplified. This in turn may cause an output gap that had emerged in normal times to dramatically diverge in abnormal times. By extension, this implies a relatively unstable growth path.

Perhaps the clearest example of a politically connected firm is a state-owned enterprise (SOE). To the extent that the government places a high priority on full employment, SOEs are

likely to be overstaffed, inefficient and loss-making entities (Kornai, 1979, 1986). This is so because the government cannot credibly commit to withdraw funding from SOEs if doing so leads to massive layoffs. SOE managers perhaps understand this conflicting position that the government faces; hence, they have an incentive to operate large firms, and the same time do little to improve operational efficiency. As the experience in former communist economies confirm, SOEs may be money-losing entities that drain fiscal resources.

Thus, in line with proposition 2a, actual output in normal times will be lower than potential output if SOEs disproportionately receive bank credit on favorable terms while privately owned and independently operated firms are disproportionately credit rationed. In abnormal times (i.e. an oil shock episode), SOEs will face stiffer competition for bank credit as the government grapples with the challenge of financing other social priorities (i.e. education, health, infrastructure development etc.). This implies that SOEs are likely to be credit rationed during abnormal times as their privately owned and independently operated counterparts. This in turn implies that multiple external financing constraints will bind; hence, both publicly- and privately-owned firms may reduce production at virtually the same time. As already noted, this may increase output volatility, and engender a relatively unstable growth path.

3. A Comparative Analysis of Jamaica and Barbados Growth Dynamics

In this section, it will be shown that the economic growth dynamics that are described in proposition 2b are consistent with the growth disparities of Jamaica and Barbados between the 1960s and 1970s. That is, not only were real per capita growth rates lower for Jamaica during the relatively normal to booming years of the 1960s, but aggregate output contracted to a much greater degree in Jamaica than in Barbados during the oil shock episode of 1973; thus, the Jamaican economy has followed a relatively unstable growth path since the 1960s.

The quantitative and qualitative data that will be employed in this comparative analysis are organized, and conveniently shown in Tables 1, 2 and 3 along with related references. In particular, Table 1 presents data on selected economic, political and social indicators for both countries. Meanwhile, Tables 2 and 3 present a list of the major economic phenomena in both countries for the following periods: 1960 - 1970, 1971 – 1980 and 1981 – 1990s. To be sure, this list is not exhaustive; however, it captures some of the most important developments that transpired in each country between the 1960s and the 1990s.

[**Insert Table 1 about here**]

There are two notable periods. First, 1973 marks the period in which both countries and the global economy were buffeted by the first oil shock of the 1970s. Second, 1972 – 1980 marks the period in which the People's National Party (PNP) governed in Jamaica. There is consensus that the PNP's adoption of democratic socialism during this period not only marked a fundamental departure from the relatively market-friendly approach of the Jamaica Labour Party (JLP) during the 1960s, but also from the relatively market-friendly approach of the Barbados Labour Party (BLP) and Democratic Labour Party (DLP) during the 1970s in Barbados (see Tables 2 and 3). According to the typology of redistributive policies that is developed in this paper, Jamaica departed from Barbados in the 1970s by adopting SPM redistributive policies. However, without an understanding of the pre-independence differences between these two countries, it may not be obvious why the former adopted such policies and not the latter. The next section addresses this issue.

[**Insert Table 2 about here**]

Background

Pre-independence Differences

The gini coefficient is a common measure of income inequality, and is defined on the interval 0 to 1, with perfect equality and perfect inequity corresponding to the lower and upper bounds, respectively. Table 1 shows that the average gini coefficients for Jamaica and Barbados were approximately 0.58 and 0.46, respectively, during the 1950s. This implies that Jamaica had greater income disparity before either country gained independence from Britain (Jamaica, 1962; Barbados, 1966). But this is not surprising because Barbados was ahead of Jamaica in terms of taking definitive steps to improve its social infrastructure (i.e. health, education, water supply and housing) in the 1950s (see Tables 2 and 3).

At the same time, if Barbados initially had less income inequality and better social infrastructure than Jamaica prior to independence, the organization of economic and social life in Barbados potentially was more likely to engender social cohesion and political stability relative to Jamaica. Alternatively, there was a potentially greater latent demand for redistributive policies among the poor in Jamaica, who would later exercise their collective power and influence on electoral outcomes in the post-independence period. This in turn implies that the fate of political polities would be predicated on the extent to which their redistributive packages met the approval of the poor, but collectively influential voters. Thus, the probability that SPM redistributive policies would be adopted during the post-independence period, conditioned on the distribution of national income, was most likely higher for Jamaica than Barbados.

Interestingly, after leading Jamaica into a new age of self-determination in 1962, the JLP was struggling to maintain its hold on power on the eve of the 1970s. On the surface, this is surprising because Jamaica had successfully attracted FDI in the 1960s to primarily finance the

expansion of the bauxite industry during a commodity boom (see Table 2). In addition, the economy was looking set for a new era of prosperity with an average per capita GDP growth rate of approximately 4.2 percent (see Table 1). However, beneath all of this, was growing discontent because the realized economic gains were concentrated in the hands of a few. Given the virtual absence of social safety nets in the form of unemployment insurance, among others, the many rural workers who were displaced from the declining agricultural sector were faced with chronic economic hardships. It is in this setting that the Michael Manley led PNP administration grew in stature on the core message of equity and social justice, and democratic socialism found friends among the bulging ranks of the unemployed and the working poor.

Post-independence Growth Challenge

If Jamaica were to be a prosperous and socially and politically stable nation in the post-independence period, a long-run economic growth strategy had to be formulated that was pro-poor and pro-growth. However, the evidence suggests that such a growth strategy has eluded Jamaica since the 1960s. The data in Table 1 seems to supports this view; specifically, it shows that although Jamaica started out in the 1950s with a gini coefficient of 0.58 compared to 0.46 for Barbados, its gini coefficient averaged 0.45 compared to 0.48 for Barbados in the 1970s. In contrast, an initial per capita income gap of $1,187 ($3,395 - $2,208) dramatically widened as aggregate output contracted considerably more in Jamaica than Barbados during the oil shock episode of 1973.

In sum, the forgoing discussion suggests that there are at least two related pre-independence differences between Jamaica and Barbados that should inform comparative analyses of their growth dynamics. First, Jamaica was initially less equal in economic outcomes relative to Barbados. And second, Jamaica had a different growth challenge going into the post-

independence period; specifically, not only did Jamaica have to at least match Barbados in terms of real per capita growth rate to prevent a major divergence in the relatively small real per capita income gap in the early 1960s; it also had to find a way to also move closer to Barbados in terms of income distribution, social infrastructure and social capital.

Macroeconomic Fundamentals and Financial Intermediation before the 1973 Oil Shock

While Jamaica entered the post-independence period as a less economically equal society relative to Barbados, a number of economic fundamentals in Jamaica were either looking relatively good or at least on par with Barbados. Table 1 shows that Jamaica had: (1) a significantly higher national savings rate; (2) a similar rate of capital formation; (3) a similarly low fiscal deficit-GDP ratio, and (4) a similar single-digit inflation rate. Altogether, the macroeconomic fundamentals looked relatively good for these two countries in the 1960s. Still, based on the trade openness measure shown in Table 1, it is clear that Barbados was integrated in the global economy through trade linkages to a significantly greater degree than Jamaica. This is actually consistent with the export-led growth strategy that Barbados adopted in the 1960s (see Table 3).

The question of whether Barbados was initially and subsequently more financially developed leading up the 1973 oil shock is an important one. This is so because the growth dynamics that are predicted in proposition 2b are predicated on financial underdevelopment as reflected in limited financial intermediation, if any. Since Jamaica's growth dynamics are more consistent with proposition 2b, it has to be established that Jamaica has been financially underdeveloped relative to Barbados to ensure internal consistency.

While there is no agreement in the finance-growth literature on which measure of financial development is superior, the three common measures are M2-to-GDP ratio, commercial

bank assets as a percentage of total financial sector assets and bank credit to the private sector as a percentage of GDP (Demetriades and Hussein, 1996; Jung; 1986; Odedokun, 1998). This paper uses the third measure.

[**Insert Table 3 about here**]

Table 1 shows bank credit as a percentage as GDP was an average of 9.5% and 27.5% for Jamaica and Barbados, respectively, during the 1960s. This implies that Jamaica was less financially developed over this period; said differently, there was apparently less financial intermediation in Jamaica relative to Barbados in the 1960s. During the 1970s, however, bank credit as a percentage of GDP averaged 43.2% and 44.6% for Jamaica and Barbados, respectively. One may be tempted to infer that financial intermediation in Jamaica was now on par with Barbados in the 1970s; however, as will be shown, such an inference is misleading, if not inaccurate. To accurately interpret the significant expansion of bank credit in Jamaica relative to its GDP in the 1970s, it is important to evaluate the differences in the macroeconomic fundamentals of both countries. This task is undertaken in the next section.

Macroeconomic Fundamentals and Financial Intermediation during the 1973 Oil Shock

Between the 1960s and 1970s, Table 1 shows that: (1) the national savings rate declined in Jamaica, but increased in Barbados; (2) the national investment rate declined in Jamaica, but remained virtually unchanged in Barbados; (3) Jamaica's fiscal deficit-to-GDP ratio increased by almost 7 times its average level in the 1960s to reach 15.5%, while Barbados' fiscal deficit-to-GDP increased by almost 2 times its average level in the 1960s to reach to 5.3%; (4) although the inflation rate moved from single digits to double digits in both countries, prices were rising 3.4% faster in Jamaica; and finally (5) with average per capita growth rates of -4.3% and 2.7% for Jamaica and Barbados, respectively, the Jamaican economy contracted considerably more than

the Barbadian economy in the 1970s; thus, while Barbados had accommodated the oil shock relatively well, Jamaica's dramatically declining macroeconomic fundamentals suggest that it had been gravely wounded by the oil shock (Worrell, 1981). Importantly, the magnitude of the contractionary effect of the oil shock on the Jamaican economy reflected multiple internal weaknesses that had accumulated in the 1970s.

Table 1 shows that the Jamaican government (i.e. PNP administration) had become a direct player in the economy in the 1970s. In short order, it acquired companies in industries ranging from banking, telecommunications, utilities, tourism, manufacturing, transportation to mining. As suggested earlier, the SOEs that operated across these sectors were disproportionately inefficient, money-losing entities that drained fiscal resources. Jamaica's fiscal deficits not only grew in line with the costly acquisitions that it made, but also in line with the relatively high operational costs that SOEs incurred compared to the value that they generated. Thus, the fact that these SOEs were present in Jamaica to a significantly larger extent than in Barbados suggests that the former had to contend with far more grave fiscal challenges during the 1970s.

To finance its rapidly growing fiscal deficit, the government resorted to financially repressive measures to mobile large amounts of funds and keep down the interest rates on borrowed funds. In particular, administrative controls coupled with high reserve requirements were employed to restrict lending to the private sector (see Table 2). In addition, the government sought to lower its cost of capital by imposing ceilings on the interest rates that banks were able to offer or charge on deposits or loans, respectively (see Table 2). Thus, although the size of the banking sector in Jamaica and Barbados were similar in relative terms during the 1970s, Jamaica perhaps still lagged Barbados in the area of financial development based its extensive use of financially repressive policies during this period.

Altogether, when we evaluate the macroeconomic fundamentals for Jamaica and Barbados in the 1970s, there are good reasons to believe that the post-independence expansion of the Jamaican banking system did not translate into financial intermediation on par with Barbados. The history of Jamaica's banking sector may be read as follows (see Table 2): (1) it played an apparently limited role, if any, in financial intermediation during the 1960s because the expansion of the bauxite industry was largely financed by FDI; (2) although the banking sector expanded in the 1970s, financial intermediation was compromised due to the pervasive use of financially repressive policies that steered credit away from the relatively productive private sector to the grossly inefficient public sector; and (3) a major breakdown of financial intermediation ensured in 1990s as some of the leading domestic commercial and merchant banks, insurance companies and building societies were deemed insolvent and/or closed.

The view that banks in Jamaica have systematically underperformed as financial intermediaries relative to those in Barbados is consistent with the findings of Iyare and Moore (2011). Specifically, the authors provide time series econometric evidence which suggests that while there is a bi-directional relationship between the financial sector and long-run economic growth in Barbados, the financial sector does not appear to have a direct impact on long-run economic growth in Jamaica. Still, a disclaimer is warranted.

Notwithstanding the evidently better performance of Barbados' banking system, the reader should understand that this paper does not suggest that Barbados represents a model for either Jamaica or other small open economies in the area of banking and finance. In fact, Barbados is yet to meet international standards in the area of banking regulations and supervision. That financial development is an unfinished agenda in Barbados is evidenced by the emergence of a striving shadow banking system. For example, the 1986 collapse of Trade

Confirmers, an unregulated finance company, illustrates an early weakness in the Barbadian regulatory and supervisory architecture that governs its financial sector (see Table 3). Therefore, both Jamaica and Barbados have much more work to do to foster greater integrity, efficiency and stability in their banking systems.

Economic Isolation versus Integration

In this penultimate section, I evaluate the different approaches that Jamaica and Barbados have taken in relation to integration in the global economy. Although Jamaica received relatively large sums of FDI in the 1960s, it was not as well-networked as Barbados in the global economy through trade linkages as suggested by its relatively low trade openness score (see Table 1). During the 1970s, a variety of measures ranging from foreign exchange control, import and export license requirements, among others, collectively made Jamaica a relatively isolated nation (see Table 1). What should be clear is that financial repression during the 1970s not only compromised the workings of the banking sector, but also the foreign exchange market. The latter undermined the ability of domestic firms to effectively participate in the global economy by either selling goods abroad, or purchasing goods from foreigners. Thus, it is not surprising that Jamaica was required to commit to both trade and financial liberalization reforms under the World Bank structural adjustment programs during the 1990s (see Table 2).

In contrast to Jamaica, Barbados has been well-networked in the global economy at least since the 1960s. This has created a particular set of challenges and priorities. In particular, external price stability is important. It is against this backdrop that Barbados' fixed (pegged) exchange regime takes on significance. In 1975, Barbados pegged its currency to the US dollar at a parity of B$2:US$1 (see Table 3). Beyond the external price stability that this currency peg engenders, it also forces the Barbadian government to be more preoccupied with fiscal

management than monetary policy. This is so because it essentially sacrifices monetary autonomy by maintaining a pegged exchange regime. In other words, the Barbadian monetary authorities have to coordinate their policies in tandem with the US Federal Reserve. This means that the former is unable to set interest rates and use other monetary instruments to maintain internal price stability (i.e. low and stable inflation rate).

Importantly, the maintenance of the currency peg regime has the potential to undermine the international competitiveness of exporters in Barbados if an inflation rate differential emerges between Barbados and the United States. Specifically, if Barbados has a higher inflation rate than the US, not only will it fail to maintain external price stability in real terms, but domestic exporters will become less internationally competitive as the Barbadian dollar appreciates in real terms. The maintenance of a fixed exchange regime necessarily implies that Barbados has to resort to a combination of fiscal consolidation, wage restraint initiatives and generally keeping wage growth in line with productivity growth. Barbados has demonstrated that it has capacity, the discipline and social capital to do so since the latter half of the 1970s, and particularly during the early 1990s (see Table 3). Specifically, Barbados successfully established a Tripartite Social Partnership (government, trade unions and private sector) that enabled it to circumvent currency devaluation while implementing a structural adjustment program under the IMF (see Table 3).

Still, given the vicissitudes of international capital markets, the maintenance of a fixed exchange regime is not without risk even when care is taken to temper "hot money" flows through capital flows (Kaminsky and Reinhart, 1998, 1999). Specifically, rapid and unanticipated cross-border capital flows may induce a currency crisis, which has the potential to induce a banking crisis. To the extent that the Barbadian government recognizes these risks, the

maintenance of the fixed exchange regime may not only serve as an institutional mechanism that fosters fiscal discipline, but also encourages the Barbadian monetary authorities to pay close attention to the financial health of the domestic banking system. While there is merit to the argument that Barbados has consistently exhibited greater fiscal discipline than Jamaica because of its fixed exchange regime (Henry and Miller, 2009), the potential for a "twin crisis" in the foreign exchange market and the banking sector suggests that a fixed exchange regime is not a costless commitment device.

4. Summary and Conclusion

This paper has developed a politics-finance-growth perspective to explain the mechanisms through which politics affects financial intermediation; and how in turn, the latter affects both the relative level of per capita income growth rates, and the relative stability of the growth paths across countries. The following two categories of redistributive policies have been conceptualized: SPM redistributive policies, which are motivated by the desire to equalize economic outcomes and engender financial exclusion; and SEM redistributive policies, which are primarily motivated by the desire to equalize opportunity and engender financial inclusion. On the one hand, SEM redistributive policies are recognized for their pro-poor and pro-growth qualities; on the other hand, SPM redistributive policies may compromise financial intermediation, which in turn may lead to a relatively low standard of living and a relatively unstable growth path.

It has been shown that Jamaica fundamentally deviated from Barbados by adopting redistributive policies of the SPM variety in the 1970s. These policies are demonstrably financially exclusive. The politics-finance-growth perspective can explain the following two observations: (1) the standard of living has been falling in Jamaica relative to Barbados since the

1960s; and (2) the real per capita income gap between Jamaica and Barbados dramatically diverged during the oil shock episode of 1973; alternatively, Jamaica has had a relatively unstable growth path relative to Barbados. To the extent that Jamaica and Barbados have approximately the same economic potential, these two observations may be attributed to the adverse and potentially long-lived effects of SPM redistributive policies on financial intermediation in Jamaica in 1970s.

It has also been found that Jamaica had a pre-independence income inequality gap with Barbados that apparently disappeared by the 1970s; however, a considerably wide real per capita gap emerged over the same period This implies that the SPM redistributive policies that Jamaica adopted may have left a considerably smaller economic pie to be shared, albeit more evenly, among a larger post-independence population. If so, then many people may have received a small slice of the actual economic pie in the 1970s compared to the 1960s. In other words, although Jamaica may have set out to raise its living standards and pull many people out of poverty, it ultimately failed to do so because the economic growth strategy that it adopted in the 1970s was demonstrably neither pro-poor nor pro-growth over the long term.

Policy Implications and Future Research

Despite a series of structural adjustment programs spanning privatization, tax reforms, trade and financial liberalization, among others, in the 1990s (see Table 2), economic prosperity continues to elude Jamaica. But this experience is not unique to Jamaica. This phenomenon has also been observed in ailing Latin American countries that have been treated by structural adjustment programs at one point or another within the last four decades. The Jamaica-Barbados disparate growth experiences provides an important lesson for developing countries that are that still grappling with the social and economic problems associated with acute income inequality

and pervasive poverty. Specifically, it cautions against the use of redistributive policies of the socio-political variety. These policies may engender financial exclusion, and thereby constrain the ability of enterprising individuals to transform new ideas to novel products and services; hence, a higher standard of living may not materialize.

However, redistributive policies of the socio-economic variety that emphasize financial inclusion offer more promise; in particular, access to finance may enable enterprising individuals in developing countries to exploit commercial opportunities, and ultimately improve their welfare. In this regard, the emerging literature on financial deepening offers a potentially fruitful direction for future (Beck and Demirgüç-Kunt, 2008; Beck, Demirgüç-Kunt and Martinez Peria, 2007). In particular, it may be worthwhile to undertake case studies on small island states to determine whether their ability to develop deeper financial markets is severely constrained by their relatively small size; and if so, how this liability of size may be overcome.

References

Acemoglu, D. & Robinson, J.A. (2013). Economics versus Politics: Pitfalls of Policy Advice. *Journal of Economic Perspectives*, 27(2), 173-192.

Aghion, P., & Bolton, P. (1997). A Theory of Trickle-Down Growth and Development. Review of Economic Studies, 64(2), 151–72.

Antoine, R.-M. (1999). *Commonwealth Caribbean Law and Legal Systems*. London: Cavendish Publishers.

Banskota, K., Johnson, S.R., & Stampley, G.L. (1987). Income Distribution in Jamaica. Staff Report 87-SR36, Center for Agriculture and Rural Development, Iowa University.

Beck, T., & Demirgüç-Kunt, A. (2008). Access to Finance: An unfinished agenda. *World Bank Economic Review*, 22(3), 383-396.

Beck, T., Demirgüç-Kunt, A., & Martinez Peria, M. (2007). Reaching Out: Access to and Use of Banking Services across Countries. *Journal of Financial Economics*, 85(1), 234-266.

Beck, T., Demirgüç-Kunt, A., & Levine, R. (2003a). Law and finance: why does legal origin matter? *Journal of Comparative Economics*, 31(4), 653-675.

Beck, T., Demirgüç-Kunt, A., & Levine, R. (2003b). Law, Endowments, and Finance. *Journal of Financial Economics*, 70, 137–81.

Blackman, C. (2006). *The Practice of Economic Management: A Caribbean Perspective*. Kingston: Ian Randle Publishers.

Bloom, D.E., Mahal, A., King, D., Henry-Lee, A., & Castillo, P. (2001). Globalization, Liberalization and Sustainable Human Development: Progress and Challenges in Jamaica. United Nation Conference on Trade and Development (UNCTAD).

Demetriades, P., & Hussein, K. (1996). Does financial development cause economic growth? Time series evidence from 16 countries. *Journal of Development Economics*, 51, 387–411.

Downes, A.S. (2001). Economic Growth and Development in Barbados during the Twentieth Century. *Integration & Trade*, 15(5): 145–176.

Handa, S., & King, D. (1997). Structural Adjustment Policies, Income Distribution and Poverty: A Review of the Jamaican Experience. *World Development*, 25(6): 915-930.

Henry, P., & Miller, C. (2009). Institutions versus policies: A tale of two Islands. *American Economic Review: Papers & Proceedings*, 99(2), 261-267.

IMF. (2010). Barbados: 2010 Article IV Consultation – Selected Issues. ÌMF Country Report No. 10/364. Washington, D.C.: IMF.

Iyare, S., & Moore, W. (2011). Financial sector development and growth in small open economics. *Applied Economics*, 43, 1289-1297.

Jung, W.S. (1986). Financial development and economic growth: international evidence *Economic Development and Cultural Change*, 34, 336–46.

Kaminsky, G.L., & Reinhart, C.M. (1998). Financial Crises in Asia and Latin America: Then and Now. *American Economic Review Papers and Proceedings*, 88(2), 444-448.

Kaminsky, G.L., & Reinhart, C.M. (1999). The Twin Crises: The Causes of Banking and Balance of Payments Problems. *American Economic Review*, 89(3), 473-500.

King, D. (2001). The Evolution of Structural Adjustment and Stabilization Policy in Jamaica. *Social and Economic Studies*, 50(1), 1-53.

Kirkpatrick, C., & Tennant, D. (2002). Responding to Financial Crisis: The Case of Jamaica. *World Development*, 30(11), 1933-1950.

Kornai, J. (1979). Resource-Constrained versus Demand-Constrained Systems. *Econometrica*, 47, 118-130.

Kornai, J. (1986). The Soft Budget Constraint. *Kyklos*, 39, 3-30.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R.W. (1997). Legal Determinants of External Finance. *Journal of Finance*, 52, 1131–1150.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R.W. (1998). Law and Finance. *Journal of Political Economy*, 106, 1113–1155.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R.W. (1999). The Quality of Government. *Journal of Law, Economics and Organization*, 15, 222–279.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R.W. (2000). Investor Protection and Corporate Governance. *Journal of Financial Economics*, 58, 3–27.

Levine, R. (1997). Financial Development and Economic Growth: Views and Agenda. *Journal of Economic Literature*, 35, 688–726.

Levine, R. (1998). The Legal Environment, Banks, and Long-run Economic Growth. *Journal of Money, Credit, and Banking*, 30, 596–620.

Levine, R. (1999). Law, Finance, and Economic Growth. *Journal of Financial Intermediation*, 8, 36–67.

Levine, R. (2005). Finance and growth: Theory and evidence. In P. Aghion & S. Durlauf (Eds.), *Handbook of Economic growth* (pp. 865–934). Amsterdam: Elsevier.

Mishkin, F.S. (2008). *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich*. Princeton: Princeton University Press.

North, D.C., Wallis, J.J., Webb, S.B., & Weingast, B.R. (2013). Limited Access Orders: An Introduction to the Conceptual Framework. In D.C. North, J.J. Wallis, S.B. Webb & B.R. Weingast (Eds.), *Politics, Economics, and Problems of Development: In the Shadow of Violence* (pp. 1-23). Cambridge: Cambridge University Press.

Odedokun, M.O. (1998). Financial intermediation and economic growth in developing countries. *Journal of Economic Studies*, 25, 203–24.

Olson, M. (1965). *The Logic of Collective Action*. Cambridge: Harvard University Press.

Payne, A. (1993). Westminster Adapted: The Political Order of the Commonwealth Caribbean. In J.I. Dominguez, R.A Pastor & R.D. Worrell (Eds.), *Democracy in the Caribbean: Political, Economic and Social Perspectives* (pp. 57-73). Baltimore: Johns Hopkins University Press.

Rajan, R.G., & Zingales, L. (2003). The Great Reversals: The Politics of Financial Development in the 20th Century. Journal of Financial Economics, 69, 5–50.

Springer, B. (2010). Barbados - public-private sector Partnership. Santiago: United Nations.

Stigler, G. (1971). The theory of economic regulation. *Bell Journal of Economics and Management Science*, 2(1), 3-21.

Stephens, E. H., & Stephens, J.D. (1986), *Democratic Socialism in Jamaica*. London: MacMillan.

Williams, E. (1970). *From Columbus to Castor. The History of the Caribbean 1492-1969*. New York: Random House.

Worrell, D. (1981). External Influences and Domestic Policies: The Economies of Barbados and Jamaica in 1970s. *Social and Economic Studies*, 30(4), 134-155.
Worrell, D. (1987). *Small Island Economies: Structure and Performance in the English Speaking Caribbean Since 1970*. New York: Prager.

Table 1: Selected Financial, Economic and Social Indicators for Jamaica and Barbados

	Jamaica	**Barbados**
Gini coefficients (households as income unit) :		
Pre-independence (1950s)	0.58	0.46
Post-independence (average, 1970s)	0.45	0.48
Gross domestic savings (% GDP):		
Pre-independence (1960)	26.0	2.2
Post-independence (average, 1970s)	18.3	10.8
Gross capital formation (% GDP):		
Pre-independence (1960)	29.7	24.2
Post-independence (average, 1970s)	17.1	23.2
Real GDP per capita (US$):		
Pre-independence (1960)	$2,208	$3,395
Growth rate of GDP per capita:		
Average (from independence to 1972)	4.2	6.0
Average (1972-1980)	-4.3	2.7
Fiscal deficit (% GDP):		
Average (from independence to 1972)	2.3	2.7
Average (1972-1980)	15.5	5.3
Inflation, consumer prices (Annual %):		
Pre-independence (1960s)	6.7	3.6
Post-independence (average, 1970s)	17.3	13.9
Trade openness (sum of exports and imports as a percentage of GDP):		
Pre-independence (1960)	71.3	109.4
Post-independence (average, 1970s)	75.8	127.8
Financial development – Bank credit as a percentage of GDP:		
Pre-independence (1960s)	9.5	27.5
Post-independence (average, 1970s)	43.2	44.6

Sources: Downes (2001, Table 2), Banskota, Johnson and Stampley (1987, Table 5), Henry and Miller (2009, Table 2) and World Bank (world development indicator database online).

Table 2: List of Major Developments

Jamaica		
1960 – 1970	1971 – 1980	1981-1990s
Economics:	Economics:	Economics:
• Focus on light manufacturing and tourism as the sugar industry declines.	• Extensive state intervention in the economy.	• Stimulus package from IMF; World Bank Structural Adjustment Loan agreement.
• Limited, if any, state intervention in the economy.	• SOEs in banking, telecommunications, utilities, tourism, manufacturing, transportation & mining.	• Relaxation, then elimination of import license requirements.
• Bank of Jamaica replaces the currency board.	• Share of public expenditure on housing, education & housing increased; subsidies on basic food items.	• Import tariffs are reduced; Common External Tariff (CET) Agreement created, but effective tariff remains high under a complex tariff structure.
• Investments & growth drivers - natural resource (i.e. bauxite) & tourism.	• Public works program - "Special Employment Program"; but limited investment in physical infrastructure (i.e. roads, water supply).	• Just before financial liberalization, additional restrictions imposed on the banking sector – credit controls.
• Foreign direct investment (FDI) accounts for 30 % of domestic capital formation, and the lion share went to the bauxite industry.	• Minimum wage is established; paid maternity leave; increase in worker dismissal costs; unions are empowered.	• Liberalization of the banking sector underway (1991) – quantitative credit controls & ceilings on savings & deposits are eliminated; but high reserve requirements remain in place.
	• Extensive use of price controls.	• Foreign exchange controls are lifted (1991), but liberalization is incomplete.
	• Foreign exchange controls; trading in the foreign exchange market is restricted to commercial banks.	• Privatization of SOEs underway.
	• Import & export license requirements.	• Tax reforms – greater focus on taxing final goods & services.
	• Jamaica Commodity Trading Corporation is established – government is now the sole importer.	• Decline in social infrastructure (i.e. school, health care facilities).
	• Hostility toward foreign-owned enterprises & FDI.	• Banking crisis (1996). Financial Sector Adjustment Company (FINSAC) is created to resolve crisis at cost of 37 % of GDP (1998); government equity stake in banks increased. Among the financial institutions deemed insolvent and/or closed are: 6 of the 9 commercial banks with a 60% share of total deposits and 5 life insurance companies with a 90% share of premium income.
	• High marginal tax rates on personal & corporate income - 80% at highest tax bracket; expansion of the informal economy.	• Hurricane Gilbert in 1988 – physical infrastructure destroyed.
	• Ceilings on interest rates on savings, deposits & loans; quantitative credit controls; high cash reserve & liquid asset ratios.	• Jamaica Promotions Corporations (JAMPRo), is established (1988) – promote trade & investment.
	• Oil shock in 1973.	
Politics:	Politics:	Politics:
• JLP (1962 -).	• PNP (1972 - 1980) – democratic socialism.	• JLP (1980-1989).
	• JLP (- 1972; 1980 -).	• PNP (1989 -).

Sources: Bloom et al. (2001), Handa and King (1997), King (2001), Kirkpatrick and Tennant (2002), Stephens and Stephens (1986) and Worrell (1981, 1987).
Notes: JLP: Jamaica Labour Party; PNP: People`s National Party; SOEs: State-owned enterprises.

Table 3: List of Major Developments

Barbados		
1960s – 1970	1971 – 1980	1981-1990s
Economics:	Economics:	Economics:
• Focus on light manufacturing and tourism as sugar industry declines.	• Currency peg is established (1975) – parity of B$2:US$1	• Introduces the first unemployment insurance scheme in the Caribbean (1981).
• Export-led growth strategy is adopted.	• Oil shock in 1973.	• Financial assistance is sought from the IMF, World Bank & Inter-American Development Bank (IADB).
• Development of social infrastructure is already underway (since late 1950s).		• Experiences one of its deepest recession in 25 years - decline in the tourism sector in the early 1990s.
• Development of various institutions to finance and promote development agenda.		• Tripartite Social Partnership (government, trade unions & private sector) is formed in 1993 to restrain wages and prices & avoid currency devaluation.
		• Collapse of Trade Confirmers (1986), an unregulated finance company.
Politics:	Politics:	Politics:
• DLP (1966 -).	• DLP (- 1976).	• DLP (- 1986).
	• BLP (1976 -).	• BLP (- 1986; 1994 -).

Sources: Blackman (2006), Downes (2001), IMF (2010), Springer (2010) and Worrell (1981).
Notes: BLP: Barbados Labour Party; DLP: Democratic Labour Party.